United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

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74-2250

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IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

THE E. R. HITCHCOCK COMPANY, a corporation,

Plaintiff-Appellee

v.

UNITED STATES OF AMERICA,

Defendant-Appellant

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF CONNECTICUT

BRIEF FOR THE APPELLANT

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STATEMENT OF THE ISSUE PRESENTED

Whether the District Court erred in holding that the entire amount awarded to taxpayer on the condemnation of its property qualified for the nonrecognition of gain treatment provided by Section 1033 of the Internal Revenue Code of 1954, even though a portion of such award represented compensation for the estimated cost of moving taxpayer's business to a new location.

STATEMENT OF THE CASE

This is an action for a refund of income taxes of $10,108.71, plus interest, for the taxable year 1966. (R. 8, 14.)[1/] The District Court, on May 28, 1974, handed down its ruling on cross-motions for summary judgment filed by the parties and entered judgment for the taxpayer on May 31, 1974. (R. 14-24.) The Government filed its notice of appeal on July 26, 1974. (R. 2.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1291.)

The relevant facts have been stipulated and are as follows

On May 24, 1965, taxpayer's business premises (land and building) located at 39 Chestnut Street, New Britain, Connecticut were taken by the New Britain Redevelopment Commission under its power of eminent domain. In June of 1965, the Commission awarded taxpayer $69,000 for the land and building. Thereafter, taxpayer applied to the Connecticut Superior Court for a review of the award. The matter was assigned to a referee who determined, in a report dated July 29, 1966, that the value of the land and building was approximately $90,000. (R.10-11, 14-15.) He further determined that taxpayer was entitled to an additional $40,000 for the estimated cost of moving its business to a new location and, accordingly, recommended a total award of $130,000. (R.11-15.) The referee's report was accepted by a judge of the Superior Court who then ordered,on September 9, 1966, that the balance of $61,000 ($130,000 less the previous award of $69,000)be paid over to taxpayer. (R. 12-13, 15.)

1/ "R." references are to the separately bound record appendix.

Taxpayer treated the total award of $130,000 as a nonseverable receipt in 1966 qualifying in its entirety for deferred recognition of gain under Section 1033(a) of the Internal Revenue Code of 1954. The District Director determined, however, that the $40,000 paid to compensate taxpayer for estimated moving expenses constituted ordinary income to taxpayer to the extent such sum exceeded taxpayer's actual moving expenses of $18,940.20. Taxpayer paid the resulting deficiency and, upon denial of its claim for refund, instituted the instant action. (R.15-17.) In the District Court, cross-motions for summary judgment were filed and the court granted taxpayer's motion holding that the entire amount of $130,000 qualified for the nonrecognition of gain treatment provided by Section 1033. (R. 14-22.) This appeal followed

SUMMARY OF ARGUMENT

Taxpayer's property was condemned by a municipal redevelopment agency, and taxpayer received a lump-sum condemnation award of $130,000. As indicated by the underlying report of the referee who appraised taxpayer's property, only $90,000 of the award was intended as compensation for the value of that property. The additional amount of $40,000, was to compensate taxpayer for the estimated cost of moving its business to a new location. Taxpayer realized gain on the additional award since its actual moving expenses were less than $40,000 and the issue to be resolved by this Court is whether taxpayer is entitled to defer recognition of that gain under the provisions of Section 1033 of the Internal Revenue Code of 1954.[2/]

2/ There is no question that gain realized by taxpayer on the basic award of $90,000 qualifies for Section 1033 treatment.

The District Court held that the entire award of $130,000 must be treated as having been paid for the value of the converted property for purposes of Section 1033, because, under Connecticut law, moving expenses are not intended to be awarded as a separate item but, instead, are to be taken into account in arriving at a so-called "fair market value" of the condemned property.

We submit that the lower court erred in relying on the characterization of taxpayer's award under state law. Although state law creates property rights and interests (here the right to receive $90,000 for the loss of the property and another $40,000 to meet its moving costs), the taxation of such rights and interests is controlled by the federal tax statutes and not by arbitrary labels attached to those rights and interests under local law. Thus, it is well established that a lump-sum condemnation award, which, for state law purposes, may be labelled as compensation for the value of the condemned property, but which in substance includes compensation for some other item of damage in connection with the transfer, must be broken down into its component parts, with only the portion actually representing the compensation for loss of title to the property being covered under the various federal tax provisions (e.g., Section 1033) dealing with such compensation. This is precisely the situation here where it is indisputable, given the referee's report, that, in substance, only $90,000 of the total award of $130,000 constituted compensation for the value of taxpayer's property. Accordingly, the court erred in ruling that the entire award qualified for deferred recognition of gain treatment under Section 1033.

The judgment of the District Court should be reversed.

ARGUMENT

THE DISTRICT COURT ERRED IN HOLDING THAT THE ADDITIONAL AMOUNT AWARDED TO TAXPAYER FOR THE ESTIMATED COST OF MOVING ITS BUSINESS TO A NEW LOCATION QUALIFIED FOR DEFERRED RECOGNITION OF GAIN TREATMENT UNDER SECTION 1033 OF THE INTERNAL REVENUE CODE OF 1954

Section 1033(a) of the Internal Revenue Code of 1954, Appendix, infra, provides that no gain shall be recognized on the involuntary conversion of a taxpayer's property into money if the taxpayer purchases replacement property within a specified period. In the instant case, taxpayer's business premises were condemned by a municipal redevelopment agency and taxpayer was awarded $90,000 for the value of its land and building and an additional $40,000 for the estimated cost of moving its business to a new location. (R. 10-13.) Taxpayer used the proceeds to acquire qualified replacement property within the prescribed period and thus the only issue to be resolved by this Court is whether the additional amount awarded to taxpayer for estimated moving expenses constitutes money into which taxpayer's "property" has been converted for purposes of Section 1033. We contend that only $90,000 of the total award of $130,000 can be considered as payment for the value of the converted property and that, therefore, the additional award of $40,000 is not covered by the provisions of Section 1033.

The District Court, in holding that the entire award of $130,000 qualified for Section 1033 treatment, erroneously relied on the characterization of that award under Connecticut law. In this regard, the court placed erroneous reliance upon the decision

of the Connecticut Supreme Court in Harvey Textile Co. v. Hill, 135 Conn. 686, 67 A. 2d 851 (1949). There the court held that moving expenses are an element of damages which must be considered in determining the "fair market value" of condemned property, not as a separate item to be added to the value of the property but rather as evidence tending to establish the property's value.[3/] It is well settled, however, that federal courts, in resolving federal tax disputes, are not bound by labels or classifications affixed for state property law purposes. Thus, in Morgan v. Commissioner, 309 U.S. 78, 80-81 (1940), the Supreme Court held that the classification of a power of appointment as "special" under state law was not controlling for federal estate tax purposes. In so holding, the Court stated the following:

> State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed. Our duty is to ascertain the meaning of the words used to specify the thing taxed. If it is found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest or right by state law. (Footnote omitted; emphasis added.)

3/ This arbitrary rule is contrary to normal use of terms. It is obvious that the existence of anticipated moving expenses of the seller would not have any effect on the fair market value of the seller's property. From a prospective purchaser's viewpoint, the seller's moving expenses are totally irrelevant, since they add nothing to the value or utility to a prospective buyer of the seller's property. Thus, in a free market, there is no reason to assume that such moving expenses could be passed on to any purchaser who would not, under the exigencies of existing market conditions, have been willing to pay that amount for the property even if the seller had no moving expenses.

See Union Planters Nat. Bank of Memphis v. United States, 426 F. 2d 115, 118 (C.A. 6, 1970).

As made clear by the above decisions and by those discussed infra, the fact that under Connecticut law all payments to a condemnee, regardless of the nature of the right being compensated, are to be lumped together in a single amount which is artificially and arbitrarily labelled as a payment for the "fair market value" of the condemned property does not require the Commissioner or the federal courts to treat the entire award as having been paid for the converted property for purposes of Section 1033. This is particularly true in the instant case where the referee's report contains a specific breakdown of the lump-sum payment to taxpayer which shows that only $90,000 of the total award of $130,000 constituted compensation for the converted property and that the remaining $40,000 was compensation for estimated moving costs. (R. 10-11.) Under these circumstances, there can be no question that the gain which the Government seeks to tax is not the gain realized by taxpayer on the conversion of his property, and which is the intended object of the benefits of Section 1033, but rather the separate gain realized by it as a result of having been able to move its business at a cost of less than the $40,000 awarded for that purpose.[4/] And this latter gain is clearly not within the ambit of Section 1033.

4/ If the owner of the converted property happened not to be occupying it at the time of the conversion, and thus had no need to move, he would have been entitled to no more than the $90,000 although the property would, nevertheless, have been converted with the meaning of Section 1033. It must then be apparent that the "amount realized upon such conversion," to which the benefits of Section 1033 are limited (see Sec. 1033(a)(3)(A)), was not more than $90,000. It is equally apparent that the additional $21,059.80 was not the proceeds

Moreover, without regard to the specific breakdown of taxpayer's award in the instant case, it is well established that lump sum condemnation awards must be broken down into their component parts for federal tax purposes. See Kieselbach v. Commissioner, 317 U.S. 399 (1943); Isaac G. Johnson & Co. v. United States, 149 F. 2d 851 (C.A. 2, 1945); Vaira v. Commissioner, 444 F. 2d 770 (C.A. 3, 1971); Johnston v. Commissioner, 42 T.C. 880 (1964); see also Graphic Press, Inc. v. Commissioner, 60 T.C. 674 (1973), appeal pending C.A. 9; Smith v. Commissioner, 59 T.C. 107 (1972); Estate of Walter v. Commissioner, P-H Memo T.C., par. 71,244 (1971).[5/]

In Kieselbach v. Commissioner, supra, the issue before the Supreme Court was whether that portion of the taxpayer's lump-sum condemnation award representing compensation for the delay in payment of the award should be treated as part of the payment for the condemned property and therefore taxable

4/ (continued) of the conversion but of the taxpayer's success in effecting the move more economically than anticipated by the state court.

Had the property been occupied at the time of the conversion by one leasing it from taxpayer, any payment for moving expenses would have gone to the lessee, thus making it further apparent that this payment was not part of the statutory "amount realized upon such conversion."

5/ The decision of the District Court in Conran v. United States, 322 F. Supp. 1055 (Mo., 1971), to the extent it holds that a lump-sum condemnation award is not severable into its component parts for purposes of determining the applicability of Section 1033, is contrary to the overwhelming weight of authority and, accordingly, should be rejected by this Court.

as capital gain,or whether it should be treated as a separate item taxable as ordinary income. Under the applicable New York law, a condemnee was entitled to "just compensation" which included compensation for the delay in payment of the award in addition to compensation for the value of the property on the date of the taking. The taxpayer contended that,since just compensation for his property required payment of the disputed sums for the delay in settlement, such sums must be regarded as part of the sales price of the condemned property. The Supreme Court rejected that contention holding (p. 404):

> While without their payment just compensation would not be received by the vendor, it does not follow that the additional payments are a part of the sale price under §117(a). 6/

Here, the moving expenses may have been necessary to achieve "just compensation," but they were not part of the proceeds of the forced sale of taxpayer's property. The decision below, contrary to the holding of the Supreme Court in Kieselbach, permits state law to prevail as to the manner in which an amount received for condemned property is to be treated for federal tax purposes since any state can provide that extras such as interest, moving expenses, and the like are to be regarded as part of the condemnation sale price.

Similarly, in Vaira v. Commissioner, 444 F. 2d 770 (C.A. 3, 1971), the taxpayer sought to establish that a portion of his

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6/ Under Sections 117(a) of the Revenue Act of 1936, C. 690, 49 Stat. 1648, only a certain percentage (30 or 40 depending on the taxpayer's holding period) of the gain realized upon the sale or exchange of a capital asset was taxable.

lump sum condemnation award represented nontaxable severance damages. The Commissioner took the position that the entire award must be treated as taxable consideration for the converted property because, under the applicable Pennsylvania law, only a general award of damages for the property taken was allowable. The Third Circuit overruled the Commissioner holding that an award of general damages merely created a presumption that the entire consideration received related to the property taken and that no part of such consideration was on account of damage to the contiguous property retained by the taxpayer. The court then went on to hold that the taxpayer's evidence was sufficient to rebut the presumption and establish that a portion of the general damage award, in substance, represented compensation for severance damages.

In Johnston v. Commissioner, supra, the Tax Court also determined that a portion of a lump sum award represented severance damages to the land retained by the taxpayer, stating (pp. 883-884):

> That tax issues are to be decided upon the basis of substance rather than form is so fundamental as to require no citation of authority. We think the fact that the award in this case was made in a lump sum under State law was mere form and that the substance of what actually occurred is amply shown by the negotiations of the parties and the factors clearly taken into consideration by the Board of View in arriving at its award * * *.

Contrary to the holdings in the above-cited cases, the decision of the court below allowing taxpayer's gain on the entire $130,000 award to be deferred under Section 1033 exaults form over substance. There can be no question, given the

determination of the referee in his report, that the substance was that only $90,000 of taxpayer's award represented compensation for the value of its land and building. Nor is it determinative that Connecticut chooses to label its lump-sum payment, contrary to the meaning of that term for federal tax purposes, as compensation for the "fair market value" of the converted property. In the first place, Section 1033 does not provide deferral benefits in terms of the fair market value of the converted property but in terms of the "amount realized upon * * * [the] conversion." Construction of the latter term is obviously a matter for the federal courts and, in any event, Connecticut law does not purport to define that term. Moreover, even if "fair market value" were the governing factor, that concept has a fixed meaning in federal tax law (the price at which a willing buyer and willing seller would exchange the property),[7/] and this meaning may not be set aside by any state which chooses to do so. While the federal courts will accept the conclusions of the state court as to the price at which the willing buyer and seller will deal, the state court may not substitute another legal test of fair market value and bind the federal courts to it. In the instant case, state law had exercised its sole prerogative in determining that the market value was $90,000,[8/] and federal law then asserts

7/ 10 Mertens, Law of Federal Income Taxation (Rev.), §59.01; Singer v. Shaughnessy, 198 F. 2d 178 (C.A. 2, 1952).

8/ As noted previously, it is certain that, with equivalent properties available at $90,000 (that being the basis of the determination of the market value of property) (see 10 Mertens, supra) the willing buyer would not pay an additional $40,000 by reference to the seller's particular moving problems.

its paramountcy in determining that the additional $40,000 for moving expenses is not part of the "amount realized" on the conversion.

The crucial and controlling fact is that the $40,000 in issue was plainly an award to compensate taxpayer for something other than the value of its condemned property and was payable to it only because it happened to be occupying the property as well as being the owner. And as stated by the Sixth Circuit in Union Planters Nat. Bank of Memphis v. United States, 426 F. 2d 115, 118 (1970):

> In cases where the legal characterization of economic facts is decisive, the principle is well established that the tax consequences should be determined by the economic substance of the transaction, not the labels put on it for property law (or tax avoidance) purposes.

CONCLUSION

The judgment of the District Court is erroneous and should be reversed.

Respectfully submitted,

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NOVEMBER, 1974.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 4th day of November, 1974, in an envelope with postage prepaid, properly addressed to him as follows:

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Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 1033. INVOLUNTARY CONVERSIONS.

(a) General Rule.--If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted--

* * *

(3) Conversion into money where disposition occurred after 1950.--Into money or into property not similar or related in service or use to the converted property, and the disposition of the converted property (as defined in paragraph (2)) occurred after December 31, 1950, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:

(A) Nonrecognition of gain.--If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock. Such election shall be made at such time and in such manner as the Secretary or his delegate may be regulations prescribe. * * *

* * *